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Income Shifting Incentives and Tax Haven Utilization: Evidence from Multinational U.S. Firms



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Abstract

This paper examines the association between a series of income shifting incentives including multinationality, transfer pricing aggressiveness, thin capitalization, intangible assets and tax haven utilization. Our empirical analysis is based on a sample of 286 multinational U.S. firms over the 2006–2012 period (2002 firm-years). Our regression results show that multinationality, transfer pricing aggressiveness, thin capitalization and intangible assets are positively associated with tax haven utilization. Our results are consistent based on several robustness checks.

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Keywords: Income shifting; Tax havens; Multinationality; Transfer pricing; Thin capitalization; Intangible assets

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1. Introduction

Tax havens³ have come under increased scrutiny from the G-20 Industrialized Nations, the OECD and various tax authorities globally, especially with regards to the issue of corporate tax avoidance⁴ (Gravelle, 2013). Although tax havens can be utilized by a firm for legitimate business purposes such as facilitating the flow of funds between corporate group members and lowering the cost of capital for the corporate group (Dyreg & Lindsey, 2009), a great deal of concern has been expressed by the Internal Revenue Service (IRS), the Government Accountability Office (GAO) and other government agencies including the Homeland Security and Governmental Affairs (HSGA) that tax havens play a major role in significantly reducing corporate tax liabilities (US Senate Permanent Subcommittee, 2006; Department of the Treasury, 2007; GAO, 2008a,b). For example, the US Senate Permanent Subcommittee (2006, p. 1) asserts that offshore tax havens have become *foci* for: “tax evasion, financial fraud and money laundering.” Specific legislation has recently been enacted in the U.S. to combat potential tax avoidance through the utilization of tax havens such as the *American Jobs and Closing Loopholes Act*, the *Stop Tax Haven Abuse Act* and the *Bipartisan Tax Fairness and Simplification Act*.

Tax havens represent multiple geographically dispersed jurisdictions that are characterized by nil or only nominal amounts of corporate taxes and have laws or administrative practices that prevent the effective exchange of information concerning financial and taxation arrangements (Wilson, 2009). While these jurisdictions hold less than 1% of the world’s population, they host 5.7% of foreign employment and 8.4% of foreign property, plant and equipment of U.S. firms (Hines, 2005). Hanlon and Heitzman (2010) claim that tax havens play a vital role in terms of debt and investment location, accounting earnings and tax revenues. In particular, tax havens act as significant offshore financial centers that facilitate the flow of capital between jurisdictions and are *loci* for special purpose financing arrangements (e.g., asset securitization and hedge funds) and businesses that are major drivers of the cost of capital (Hanlon & Heitzman, 2010). In fact, many multinational firms incorporate their treasury function in tax havens which are likely to facilitate the flow of capital between group members without the associated impediment of complying with strict regulation and enforcement around information flows and capital management requirements (Dyreg & Lindsey, 2009; Gravelle, 2013).

³ Various governmental, international and academic sources define tax havens on the basis of several analogous characteristics (Dyreg & Lindsey, 2009; Hines & Rice, 1990; Wilson, 2009; Government Accountability Office [GAO], 2008a,b; Organisation for Economic Cooperation and Development [OECD], 2012a). Specifically, tax havens are jurisdictions that offer beneficial financial, legal and tax regimes. The OECD (2006) has established a list of 33 tax haven jurisdictions denoted as follows: Anguilla, Antigua and Barbuda, Bahamas, Bahrain, Bermuda, Belize, British Virgin Islands, Cayman Islands, Cook Islands, Cyprus, Dominica, Gibraltar, Grenada, Guernsey, Isle of Man, Jersey, Liberia, Malta, Marshall Islands, Mauritius, Montserrat, Nauru, Netherlands Antilles, New Caledonia, Panama, Samoa, San Marino, Seychelles, St. Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, Turks and Caicos Islands and Vanuatu.

⁴ Corporate tax avoidance is defined in this study as any transaction or event (“passive” or “aggressive”) that leads to a reduction in the amount of corporate taxes paid by a firm (Dyreg et al., 2008). Tax avoidance can be viewed as a continuum whereby taxes payable can be reduced through legitimate methods in accordance with tax legislation provisions or through illegal means or means that are not in compliance with tax legislation provisions or exploit aggressively the intent or meaning of tax provisions (Hanlon & Heitzman, 2010).

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